Is the Public Interest Served by Risk Pooling?

An Honors Thesis (HONRS 499)

by

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May 1996

Date of Graduation: May 4, 1996

Purpose of Thesis

This discussion of risk pooling, with a concentration in worker's compensation, is designed to provide a better understanding of pools and their impact on society and the insurance industry. The discussion includes an overview of worker's compensation insurance and an explanation of risk pooling. It also includes research from individual states regarding reasons for formation of pools as well as advantages and disadvantages of pools. Finally, the discussion includes a study of a proposal before the Indiana General Assembly to set up a worker's compensation pool in Indiana as well as an example of an insolvent pool in Colorado.

Insurance, as a whole, is a heavily regulated industry. Each state has an Insurance Department that is responsible for the regulation of insurance rates as well as the behavior of companies doing business in each particular state. Differences in regulation from state to state cause problems for insurance companies attempting to do business in more than one state. Each particular state has different exposures. An individual line of insurance may be in heavy demand in one part of the country and have very little demand in another part. It is for this reason that the individual states have control over the regulation of insurance. Each line of insurance must comply with the regulations set forth by each state. Due to the differences in exposures from state to state, a particular line of insurance may be regulated more heavily in one part of the country and less in other parts. However, one type of insurance that is subject to heavy regulation in all states is Workers (formerly Workmen's) Compensation.

Workers compensation insurance is an essential coverage for employers. All employers subject to the workers compensation statutes in a particular state are required to purchase workers compensation insurance for their employees. The standard workers compensation and employers liability policy provides the insured with two broad coverages: 1) Workers Compensation--pertaining to the employer's obligation to provide workers compensation benefits as set forth in applicable statutes, and 2) Employers Liability--pertaining to the employer's liability exposures under the common law system (Wiening, 254).

The most widely used workers compensation and employers liability policy is that of the National Council on Compensation Insurance. The workers compensation section covers the insured's obligations for occupational injury and disease under applicable statutes. The insuring agreement states "We (the company) will pay promptly when due the benefits required of you (the insured) by the workers compensation law" (Wiening, 254). A policy definition will spell out what is meant by the workers compensation law. This definition states "Workers Compensation Law means the workers or workmen's compensation law and occupational disease law of each state or territory named in the Information page" (Wiening, 255). The policy declarations will spell out the different state(s) or territory(ies) whose workers compensation laws apply. It is not necessary for a workers compensation policy to set dollar limits on coverage because the appropriate workers compensation statutes will state the limits that apply.

In general, all workers compensation statutes state that employers subject to the statute are required to pay medical expenses and compensation for disability or death resulting from employment related injury or disease. Currently, all states require the payment of medical expenses with no upper dollar limit (Wiening, 255). However, compensation for disability, death, dismemberment, and other related benefits are regulated by the specific limits set forth in each applicable statute.

Rate calculation in workers compensation is slightly different than in other lines of insurance. For the purpose of calculating appropriate rates, businesses are placed in different rate categories, each having its own specific classification number. This classification is necessary to ensure that businesses are charged an appropriate rate for the amount of risk that employees face in their everyday work. For example, clerical workers do not have as great of a risk of injury as do construction workers. It would not make sense to group these two occupations together when calculating rates. These classifications also benefit an employer that has different employees facing different amounts of risk. For example, the owner of a construction company would be overcharged if all employees were classified as carpentry workers. Construction companies have employees that work the computers, calculate payroll, and furnish supplies. These types of jobs have considerably less risk, and are classified as such.

In addition to purchasing workers compensation through a regular insurance carrier, some employers elect to group self insure. Group self insurance is a method of insurance coverage in which a group of employers in related industries come together and take the money that was formerly spent on conventional insurance coverage and create an alternative mechanism which operates like a reciprocal insurance company. A reciprocal insurance company is a company formed solely to insure the exposures of its owners. Similarly, employers form these self insurance groups to insure the risks of the group members. A third party administrator with insurance experience is generally hired by the group to adjust its claims.

Each employer joining the group will pay a premium, similar to conventional insurance coverage. These premiums collected are used to pay claims and to cover the administrative expenses necessary to keep the fund operating. These group funds are not formed for the purpose of making a profit. Therefore, any premiums collected that are over and above what is necessary to pay for claims and administrative expenses are returned to the member employers in the form of a dividend. In the event that collected funds are insufficient to pay claims, the members of the group are liable for the additional amounts necessary. When an employer joins the group, he or she agrees to be bound by a joint and several liability agreement. This liability is spread among the group members as an assessment.

In an attempt to study these self insurance groups, or risk pools, and their impact on conventional insurance and society, a brief survey was prepared and mailed to 46 insurance organizations in 23 states across the country. The states chosen to participate in the study include Alabama, Arizona, Arkansas, California, Colorado, Florida, Illinois, Indiana, Kentucky, Louisiana, Michigan, Minnesota, Missouri, Nebraska, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Vermont, and Virginia. In order to generate opinions from different organizations involved in this issue, each state mentioned above received two surveys. One survey was mailed to the Independent Insurance Agents Association in each state in an attempt to understand the views of the conventional marketplace. Another survey was mailed to the Insurance Department of each selected state to gain insight into the views of the state regulators. A copy of the survey as well as lists of names and addresses of the people and organizations who were selected to participate in the study can be found in the Appendix section.

The survey response rate varied between the Insurance Agents and the Insurance Departments. The usable response rate of the Insurance Agents was 43.5% (10/23). The usable response rate of the Insurance Departments was slightly higher at 52.2% (12/23). The overall response rate was 47.8% (22/46). Of the usable surveys that were returned, 90.9% (20/22) came from states that currently allow risk pooling, with the remaining two coming form Indiana, a state that does not allow pooling of risks. Since the major aim of this study is to evaluate performance of pools and their impact on society, the large number of responses from pooling states provides a sizable amount of usable information. Also of importance is the number of respondents that allow pools to form for the purpose of securing coverage for the workers compensation exposure, the main exposure focused on in the study. Ninety-five percent (19/20) of the pooling states that responded listed workers compensation as the primary form of pooling in their respective state. The response rate of pooling states coupled with the concentration on workers compensation allows for accurate generalizations to be made about the practice of risk pooling.

The survey itself contains six questions for the states that allow pooling and four questions for the states that do not allow pooling. The first question, posed to all respondents, simply asked if the respondent's state allowed group self insurance and/or risk pooling. The remaining five questions asked of the states that allow pooling are as follows:

2. What lines of insurance are allowed to pool risks?
3. In your opinion, what factors contributed to the formation of these pools?
4. What advantages or disadvantages are created by the use of a pooling mechanism?
5. Are pools currently gaining or losing market share?
6. Additional Comments.

The following three questions were asked of the states that do not allow risk pooling:

7. In your opinion, why have pools not formed in your state?
8. Do you anticipate any pooling activity in the future?
9. Additional Comments.

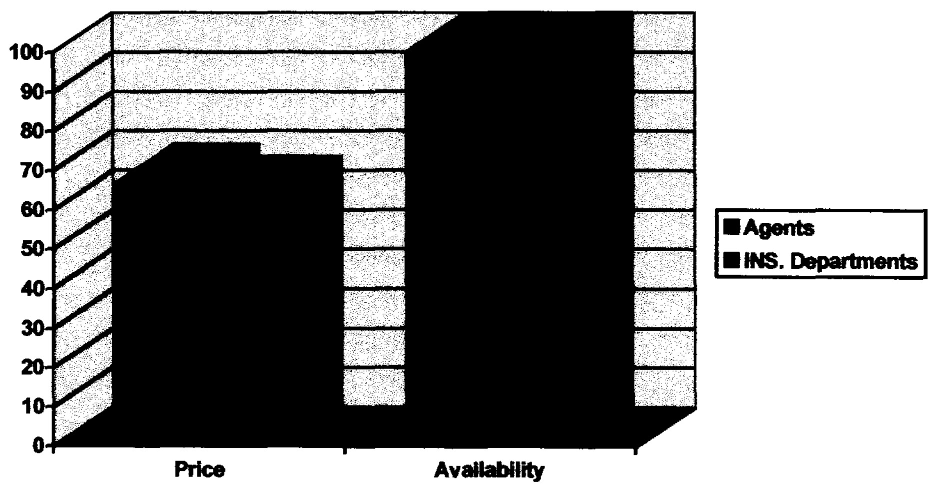
Of all of the questions posed in the survey, the ones having the most relevance and importance to this study deal with the factors contributing to the formation of pools as well as the advantages and disadvantages of a pooling mechanism. The responses to these particular questions varied slightly between the Insurance Departments and the Insurance

Agents. However, the difference was not significant enough to generate any reasons why or to suggest radically different views on the subject. In fact, as the data shows, the two entities feel the same across the country.

Factors Contributing to Pool Formation

Question #3 asked the opinion of the respondent on why pools formed in their particular state. In general, all of the respondent's furnished the same answer. Chart 1, below, shows the responses of the Insurance Agents and the Insurance Departments regarding this question.

CHART 1
Factors Contributing to Pool Formation

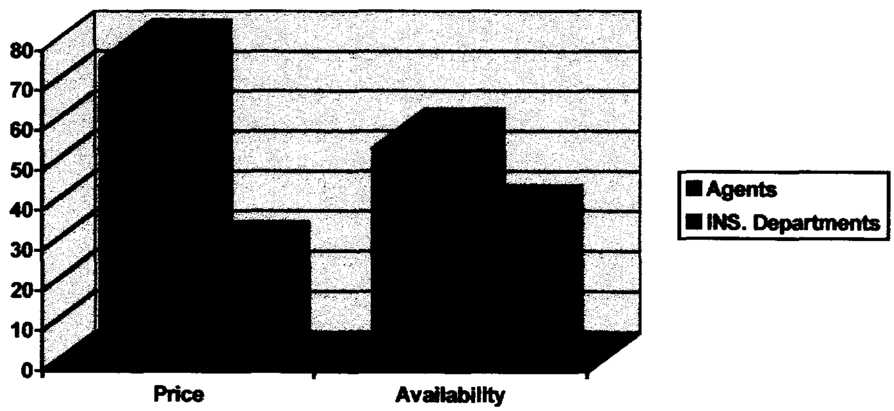


The graph clearly shows the concentration of contributing factors in two areas. Price and availability were the only responses to be mentioned more than once. Lack of availability of coverage in the conventional market seems to be the most crucial factor in the formation of self insurance groups. All of the respondents listed availability as a reason for pool formation. Price seems to be another critical factor in the formation of pools. Seven of the eleven (63.6%) responses from the Insurance Departments listed price as a primary concern in pool formation. Similarly, six of the nine (66.7%) Insurance Agents responding listed price as a primary concern.

Advantages of a Pooling Mechanism

Next, respondents were asked to list advantages they can see to the use of risk pooling in their particular state. Similar to the Contributing Factors question, only two responses were seen more than once. Lower premiums and availability of coverage were again the dominant responses. Chart 2 shows the percentage of respondents listing price and availability as advantages.

CHART 2
Advantages of Pooling



The question on advantages did not generate as many total responses as the Contributing Factors question. However, the listed responses centered on the areas of price and availability. Seven (77.8%) of the Insurance Agents listed price as an advantage while three (27.3%) of the Insurance Departments did so. Five (55.5%) of the Insurance

Agents and four (36.4%) of the Insurance Departments listed availability as a second primary advantage to forming self insurance groups.

Disadvantages of a Pooling Mechanism

Along with the advantages of using pools to insure, respondents were asked to list any disadvantages seen. As with the advantages, the disadvantage section generated fewer numbers of responses. In fact, only one response was seen more than once. The burden of joint and several liability was the predominant disadvantage cited in the study. It was cited in 11 (55%) of the 20 responses from pooling states. Four (44%) of the Insurance Agents and seven (63.6%) of the Insurance Departments listed joint and several liability as a disadvantage to the pooling mechanism.

As mentioned earlier in the study, Indiana was the only non-pooling state to respond to the survey. While this is not enough information to generate hard facts about non-pooling states, Indiana's responses seem to fit with the responses of the majority of the pooling states. For example, when asked why pools have not formed in Indiana, the Insurance Department and the Agents Association mentioned Indiana's excellent insurance marketplace. Both entities cited competitive rates and adequate coverage availability as reasons for pools not forming in Indiana. Market availability and the low rates would prevent Indiana pools from being competitive with the conventional market.

Even with Indiana's favorable market condition, attempts are still made to form self insurance groups. In the past legislative session, a bill was introduced in the Indiana House to set up a workers compensation self insurance group. House Bill No. 1362 provides that an employer may join a workers compensation self insurance group consisting of at least 11 employers for the purpose of pooling liabilities under the workers compensation law. The bill was introduced in the Second Regular Session of the 109th General Assembly in 1996. Given Indiana's current market for workers compensation insurance, the bill was defeated.

In addition to considering Indiana's current state of market availability and competitive pricing, the content of the bill itself needed to be looked at in evaluating its appropriateness for passing. The first section of concern in House Bill No. 1362 is Sec. 3. Sec. 3 states that a workers compensation pool that gains acceptance by the workers compensation board is not an insurance company; therefore, it is not subject to the insurance laws and regulations of the state of Indiana. This provides for several potential problems. For the most part, members of this pool would be in charge of themselves. This is a concern because the members have little or no insurance experience. When it comes time for solvency review, the members of the pool may not know what to look for as potential causes of failure. The State Insurance Department is experienced in this area. Also, is it possible for an entity such as this to be unbiased in its regulation? It is easier to overlook potential problems when one is evaluating one's self.

Another area of concern dealing with regulation is the pool's exemption from premium taxes and exemption from the state guaranty fund. The proposed pool would form its own group guaranty fund through assessment of its members. Chapter 5.2 of the bill sets up the guaranty fund. If one group fails to meet its claims obligations, the group guaranty fund is established to meet the obligations of the defaulting group. Of concern here is the effectiveness of the fund. The question is whether or not an inexperienced group can effectively manage the fund and distribute the compensation benefits in a timely manner. The state guaranty fund is experienced in such matters.

A third area of concern is the type of accounting system proposed by the group. The proposed group will comply to the GASB 10 accounting system as opposed to the STAT system used by conventional insurers. The main area of concern with the GASB 10 system is what can be counted as assets. Under GASB 10, items such as furniture and fixtures and prepaid expenses can be listed as assets. The conventional insurers using the STAT system can only list liquid assets. The use of such things as furniture and fixtures as assets may make a pool look better off financially than it actually is which may entice an unsuspecting employer to join the pool thinking that it is financially stable. A 1993 study of governmental risk financing pools found that more than 96% of reporting pools (214 pools reporting) comply with GASB Statement 10 (Young, 5).

A fourth area of concern with the pool is its joint and several liability provision. A workers compensation pool in Colorado failed, in part, because of this provision. The pool was formed in 1985 as the County Workers' Compensation Pool (Theis, 1). It was a pool of virtually all of the counties in Colorado joined for the purpose of insuring the workers compensation exposure. At formation, $1.3 million in county contributions had been collected. This was enough to fund expenses and losses up to the aggregate attachment point. Relying on the advice of its principal consultant (who was not an insurance consultant or actuary), the County Worker's Compensation Pool (CWCP) elected not to purchase excess aggregate coverage because of the high attachment point that the board figured would never be reached.

Over the next several years, statutory changes providing greater protection led to a dramatic and unexpected rise in the amount of workers compensation claims. In 1988, it became clear that the pool did not have adequate funds to cover claims and would have to asses its members for the claims of this and previous years (Theis, 1). Three of the member counties refused to pay the assessment saying that they understood the pool to be fully funded and stable at the outset and they should not be responsible for the negative experience of other counties (Theis, 1). The Colorado Division of Insurance took the position that the pool was insolvent since its reserves were insufficient to cover accumulated claims.

The Colorado County case provides three examples of problems with pooling. Not being subject to normal insurance regulation, the pool is forced to rely on itself to properly manage its operations. The first problem in the case occurred when the pool did not purchase the excess coverage. The pool relied on the advice of its consultant who was not experienced in such matters. The consultant made a mistake in estimating the amount of future claims. This mistake may have been avoided by an actuary or insurance consultant. The second and third problems concern the assessment of group members for unpaid claims. According to the 1993 study, 83% of reporting pools can assess members, with nearly 70% of pools having unlimited assessment capability (Young, 5). No matter what the by-laws of the pool say regarding this issue, surprises, like assessments, are not always welcomed. When someone refuses to pay, it is harder for a pool to collect the necessary funds because of the lack of government regulation. Ultimately, the burden of paying the claims may fall on the taxpayers, who are already paying for conventional insurance.

"Workers comp is fast becoming the top risk management issue of the 1990's," said James A. Swanke Jr., director of risk management services for the Wyatt Co. in Boston (Woolsey, 13). Mr. Swanke is correct. Workers compensation is a highly controversial line of insurance. The differences in the markets across the country make for difficulties in regulating the workers compensation line. Workers compensation insurance is forced to rely heavily on governmental legislation when making underwriting and claims estimation decisions. Unexpected changes in legislation can dramatically increase the amount of claims filed, as demonstrated in the failed pool in Colorado.

Hard markets, meaning that very little insurance coverage is available at an extremely high price, are forcing some employers into making decisions about alternative coverage methods. A decision to pursue coverage through self insurance groups is becoming a popular alternative to high-priced, conventional insurance. As cited by the respondents to the survey, these groups provide coverage, at a low price, that is otherwise unavailable through the conventional market. However, at what price to society is this insurance made available?

It is the conclusion of this study that society does not benefit from the use of self insurance groups. While the members of the group may benefit in the short run by securing coverage at a competitive rate, the longrun performance of the pool is uncertain when compared to traditional insurers. As demonstrated in the Colorado County case, pool administrators often do not have the experience necessary to effectively run and oversee the performance of the pool. Exemptions from government regulations may allow potentially insolvent pools to slip through the cracks. Also, potential insolvencies may be harder to identify because of the improved financial condition offered by the widespread use of GASB Statement 10 accounting.

Once a pool is judged to be insolvent, the exemption from the state guaranty fund hinders the ability of the pool to collect the amount of the unpaid claims. Conventional insurers are assessed premium taxes to provide money for the state guaranty fund. If a pool fails and is unable to collect the amount of unpaid claims, the burden of payment may fall on the taxpayers. This means that insureds securing coverage through the conventional market could end up paying for the insolvencies of traditional insurers as well as the pools. While this may be good for the members of the pool, it does not serve the public interest.

Works Cited

Theis, B. Lawrence. "Colorado County Pool Case Provides Lessons." Governmental Risk Management Reports January 1993: 1-3.

Wiening, Eric A. Insurance Contract Analysis Malvern, Pennsylvania: American Institute for Chartered Property Casualty Underwriters, 1992.

Woolsey, Christine. "Self-insuring: Is it Good for What Ails Work Comp?" Business Insurance 9 September 1991: 13, 14.

Young, Peter C. Intergovernmental Pooling: Scope and Practices Virginia: Public Risk Management Association (PRIMA), 1994.

Appendices

Appendix A - Sample Cover Letter

Appendix B - Group Self Insurance Questionnaire

Appendix C - List of Participating Insurance Departments

Appendix D - List of Participating Insurance Associations

Appendix A

«Association»
«Street»
«City, State» «Zip»

Dear Sir or Madam:

My name is Andy Dillow. I am a senior Insurance Major at Ball State University in Muncie, Indiana. I plan to graduate with an Honors Diploma in May of 1996. In order to fulfill my requirements for the Honors Diploma, I am conducting research and writing a paper on Group Self Insurance and/or Risk Pooling. Enclosed is a brief survey containing a few questions about pooling. I ask that you please take a few moments to complete the questionnaire. Thoughtful completion of the questionnaire will provide me with useful information to use in my research paper.

In addition to completing the questionnaire, if you would send any information you may have on the formation, operation, or failure of any pools in your state, it would be greatly appreciated. I have enclosed a SASE for your convenience in returning all materials.

If possible, I ask that you respond no later than ***April 1, 1996***. I plan to graduate at the beginning of may, and must have this paper finished by graduation. Any swiftness on your part to respond will make the process easier.

I thank you for your time and hope that my research will help the insurance industry as a whole as well as provide me with information for my research paper.

Sincerely,

Andy Dillow

Enclosures

Appendix B

Group Self Insurance Questionnaire

1. Does your state allow group self insurance and/or risk pooling? ___Yes ___No

If yes, goto #2 If no, goto #7

2. What lines of insurance are allowed to pool risks?

3. In your opinion, what factors contributed to the formation of these pools?

4. What advantages or disadvantages are created by the use of a pooling mechanism?

Advantages

Disadvantages

5. Are pools currently gaining or losing market share?

6. Additional Comments

Group Self Insurance Questionnaire

7. In your opinion, why have pools not formed in your state?

8. Do you anticipate any pooling activity in the future?

9. Additional Comments

Appendix C

Dept. of Insurance	State of Alabama	135 S. Union St.	Montgomery, AL	36130
State of Arizona	Dept. of Insurance	2910 N. 44th St., Suite 210	Phoenix, AZ	85018
Arkansas Ins. Dept.	1123 S. University	Suite 400, University Tower Bldg.	Little Rock, AR	72204
Dept. of Insurance	300 Capitol Mall	Suite 1500	Sacramento, CA	95814
Colorado Division of Ins.	Dept. of Regulatory Services	1560 Broadway, Suite 850	Denver, CO	80202
Dept. of Insurance	State of Florida	State Capitol, Plaza Level Eleven	Tallahasse, FL	32399
Dept. of Insurance	State of Illinois	320 W. Washington St. 4th Floor	Springfield, IL	62767
Dept. of Insurance	311 W. Washington St	Suites 103 & 300	Indianapolis, IN	46204
Dept. of Insurance	P.O. Box 517	215 W. Main St.	Frankfort, KY	40602
Dept. of Insurance	State of Louisiana	P.O. Box 94214	Baton Rouge, LA	70804
Insurance Bureau	Dept. of Commerce, State of Michigan	P.O. Box 30220	Lansing, MI	48909
Dept. of Commerce	State of Minnesota	133 E. 7th St.	St. Paul, MN	55101
Dept. of Insurance	State of Missouri	P.O. Box 690	Jefferson City, MO	65102
Dept. of Insurance	Terminal Building	941 'O' Street, Suite 400	Lincoln, NE	68508
Dept. of Insurance	State of New York	160 W. Broadway	New York, NY	10013
Dept. of Insurance	State of North Carolina	P.O. Box 26387	Raleigh, NC	27611
Dept. of Insurance	State of Oklahoma	P.O. Box 53408	Oklahoma City, OK	73152
Insurance Division	350 Winter St., N.E.	Room 440-1	Salem, OR	97310
Insurance Dept.	Commonwealth of Pennsylvania	1326 Strawberry Square	Harrisburg, PA	17120
Dept. of Insurance	1612 Marion St.	P.O. Box 100105	Columbia, SC	29202
Dept of Insurance	State of Texas	P.O. Box 149104	Austin, TX	78714
Division of Insurance	Dept. of Banking, Insurance & Securities	89 Main St., Drawer 20	Montpelier, VT	05620
Bureau of Insurance	Commonwealth of Virginia	P.O. Box 1157	Richmond, VA	23218

Appendix D

Alabama Independent Insurance Agents	P.O. Box 320410	Birmingham, AL	35232
IIA&B of Arizona	2828 N. 36th St., Suite C	Phoenix, AZ	85008
IIA of Arkansas	P.O. Box 24808	Little Rock, AR	72221
IBA West	101 Market St., Suite 702	San Francisco, CA	94105
PIIA of Colorado	801 E. 17th Ave.	Denver, CO	80218
Florida Association of Ins. Agents	P.O. Box 12129	Tallahassee, FL	32317
PIIA of Illinois	2205 Wabash Ave., Suite 206	Springfield, IL	62704
IIA of Indiana	3435 West 96th St.	Indianapolis, IN	46268
IIA of Kentucky	10221 Linn Station Rd.	Louisville, KY	40223
IIA of Louisiana	Suite 2020, One American Place	Baton Rouge, LA	70825
Michigan Association of Ins. Agents	P.O. Box 80620	Lansing, MI	48908
Minnesota Independent Ins. Agents	7300 Metro Blvd., Suite 605	Edina, MN	55439
Missouri Association of Ins. Agents	P.O. Box 1785	Jefferson City, MO	65102
IIA of Nebraska	P.O. Box 30716	Lincoln, NE	68503
IIA Association of New York	109 Twin Oaks Dr.	Syracuse, NY	13206
IIA of North Carolina	P.O. Box 10097	Raleigh, NC	27605
Oklahoma Assn. of Ins. Agents	P.O. Box 18428	Oklahoma City, OK	73154
IIA of Oregon	2701 NW Vaughn, Suite 760	Portland, OR	97210
IIA of Pennsylvania	2807 N. Front St.	Harrisburg, PA	17110
IIA of South Carolina	P.O. Box 210008	Columbia, SC	29221
Texas Assn. of Ins. Agents	P.O. Box 684488	Austin, TX	78767
IIA of Vermont	P.O. Box 1387	Montpelier, VT	05602
IIA of Virginia	8600 Mayland Dr.	Richmond, VA	23229